COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, JUNE 19, 2006

APPLICATION OF

DELMARVA POWER & LIGHT COMPANY

For an increase in its electric rates pursuant to
Va. Code § 56-249.6 and § 56-582

CASE NO. PUE-2006-00033

APPLICATION OF

DELMARVA POWER & LIGHT COMPANY
and
CONECTIV ENERGY SUPPLY, INC.

For approval of transactions under Chapter 4
of Title 56 of the Code of Virginia

CASE NO. PUE-2006-00032

FINAL ORDER

On March 10, 2006, Delmarva Power & Light Company ("Delmarva" or "Company") filed an application with the State Corporation Commission ("Commission") in which Delmarva seeks an increase in its fuel factor pursuant to the provisions of §§ 56-582 B (i) and 56-249.6 of the Code of Virginia ("Code") ("Capped Rate Adjustment Application").[1] Delmarva serves "approximately 22,000 customers in the Eastern Shore counties of Accomack and Northampton, Virginia."[2] Delmarva explains that "[b]ecause the Company owns no electric generating facilities, it must purchase all of the power it supplies to its customers."[3] Delmarva states that as a result of a competitive bidding process it has contracted with its affiliate, Conectiv Energy Supply, Inc. ("CESI"), "to supply all of Delmarva's electric power requirements for its Virginia

[1] On April 18, 2006, Delmarva filed a Motion to Update Application, with revisions to Attachment C and page 6. Such motion was previously granted.

[2] Capped Rate Adjustment Application at 1.

[3] *Id.* at 3.

retail customers beginning June 1, 2006."[4] Delmarva requests "an increase in the Company's rates to include its cost of purchasing wholesale electric power to serve its Virginia customers beginning June 1, 2006."[5] Delmarva states that the "revised rates would result in an annual increase in charges to Delmarva's Virginia retail customers of approximately $20 million, a 49.5% increase above current rates based on the 12 months ended December 31, 2005."[6]

In addition, on March 10, 2006 Delmarva and CESI filed an application with the Commission seeking "such authority under Chapter 4 of Title 56 of [the Code] as may be required for Delmarva to purchase electric power from CESI" ("Affiliates Act Application").[7] The Company and CESI state that pursuant to the "competitive solicitation" process referenced above, "Delmarva has entered into a contract with CESI . . . that provides for CESI to supply 100% of Delmarva's Virginia retail customers' default service requirements for a 12-month term commencing on June 1, 2006."[8] Delmarva and CESI assert that "[i]t is appropriate that the transaction described in [the Affiliates Act Application] be approved because it will not result in any subsidization by Delmarva's Virginia electric service customers," that the rate "increase is reasonable and in the public interest because it was the result of a competitive bidding process," and that "[t]his transaction is designed to permit Delmarva to recover its actual costs of purchased power."[9]

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[4] *Id.* at 4-5.

[5] *Id.* at 1.

[6] *Id.* at 3.

[7] Affiliates Act Application at 1.

[8] *Id.* at 5.

[9] *Id.* at 8.

On April 3, 2006, the Commission entered an Order for Notice and Hearing that, among other things: (1) docketed the Capped Rate Adjustment Application and the Affiliates Act Application, noting that these dockets will be considered together without consolidation; (2) extended the review period for the Affiliates Act Application for an additional thirty (30) days pursuant to § 56-77 of the Code; (3) provided interested persons an opportunity to submit written and electronic comments on the applications; (4) provided for the participation of respondents; (5) directed the Commission's Staff ("Staff") to investigate the reasonableness of the applications; (6) established a schedule for the filing of testimony; (7) scheduled a public hearing for May 16, 2006 to receive comments from members of the public and evidence on the applications; (8) directed Delmarva to publish notice of its applications on or before April 15, 2006 and to serve a copy of the Order for Notice and Hearing on the Chairman of the Board of Supervisors and county attorney of each county and upon the mayor or manager of every city and town (or upon equivalent officials in counties, towns and cities having alternate forms of government) in which the Company provides service on or before April 11, 2006; and (9) permitted the parties to file legal memoranda addressing the applicability – to the instant dockets – of the Memorandum of Agreement ("MOA") adopted by the Commission in approving Delmarva's proposed divestiture of its generation assets in Case Nos. PUE-2000-00086 and PUA-2000-00032.

On May 10, 2006, Delmarva filed two documents. First, Delmarva filed a letter with the Clerk of the Commission explaining that the Company had not fully complied with the notice requirements contained in the April 3, 2006 Order for Notice and Hearing. Specifically, Delmarva did not timely serve the required notice "on the governmental officials within Delmarva's Virginia service territory."[10] Second, the Company filed a Motion whereby

[10] Delmarva's May 10, 2006 Letter at 1-2.

"Delmarva places before the Commission and can support the implementation of the voluntary [Residential Rate] Mitigation Plan set forth on Exhibit A to this Motion."[11] The Company's proposed Mitigation Plan allows customers to opt-in to a three-step phase-in of the rate increase requested by Delmarva in this proceeding.

On May 11, 2006, Staff filed a Response to Delmarva's May 10, 2006 Motion. If the Commission decides to consider Delmarva's Mitigation Plan, Staff urged the Commission to require the Company to amend its application, to permit another round of pre-filed direct and rebuttal testimony, and to reschedule the evidentiary hearing. In addition, Staff included a copy of a letter to Staff dated May 10, 2006 from Katherine H. Nunez, County Administrator of Northampton County, requesting the Commission to reschedule the May 16, 2006 hearing as a result of Delmarva's untimely notice to government officials.

On May 12, 2006, Delmarva filed a Response to Staff's May 10, 2006 Response. Delmarva stated that it would support moving the evidentiary hearing to a later date if the Commission:

> (1) approves preliminarily the implementation of the purchase power supply contract between Delmarva and CESI effective June 1, 2006, subject to further hearing and order of the Commission; (2) permits the 15% increase in total charges to all customers to go into effect on June 1 pursuant to the Mitigation Plan that provides for the deferral and eventual recovery of the actual cost of purchased power, subject to further hearing and order of the Commission; and (3) allows the uncollected purchased power costs as of June 1, 2006 to be deferred as a regulatory asset, without a carrying charge, subject to further hearing and order of the Commission.[12]

On May 12, 2006, the Attorney General's Division of Consumer Counsel ("Consumer Counsel") filed a Response "to the May 12, 2006 'Response to Staff Response' filed by

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[11] Delmarva's May 10, 2006 Motion at 4.

[12] Delmarva's May 12, 2006 Response at 3.

[Delmarva]."[13] Consumer Counsel requested a delay of the procedural schedule and opposed the Company's Mitigation Plan.[14]

A public hearing was held on May 16, 2006. Richard D. Gary, Esquire, and Guy T. Tripp III, Esquire, appeared on behalf of Delmarva. Maureen Riley Matsen, Esquire, C. Meade Browder, Jr., Esquire, and D. Mathias Roussy, Esquire, appeared on behalf of Consumer Counsel. William H. Chambliss, Esquire, and Arlen K. Bolstad, Esquire, appeared on behalf of Staff. The Commission heard argument on various issues in this proceeding. In addition, the following public witnesses testified in opposition to all or part of Delmarva's requests: the Honorable Nick Rerras, Member, Senate of Virginia; Joseph P. Zager of Shore Memorial Hospital; Gene Erb of Shore Memorial Hospital; Joe Bongiovanni; Peter Laylor; and Francis Burnham.

On May 16, 2006, the Commission issued an Order that, among other things: (1) scheduled a second public hearing for June 6, 2006 to receive comments from members of the public and to receive evidence; (2) extended the date for submitting written and/or electronic comments from April 25, 2006 to June 1, 2006; (3) extended the date for filing a notice of participation as a respondent from April 25, 2006 to June 1, 2006 and provided that such parties may present *ore tenus* testimony at the June 6, 2006 evidentiary hearing; (4) granted Delmarva's Motion to consider its Mitigation Plan to the extent that the Commission will receive *ore tenus* testimony, and hear argument, on the Mitigation Plan from all participants at the evidentiary hearing on June 6, 2006; (5) directed that Delmarva's current fuel factor shall remain unchanged pending further order of the Commission; (6) disapproved the Affiliates Act Application without prejudice; (7) granted Delmarva an interim exemption under § 56-77 B of the Code to engage in

[13] Consumer Counsel's May 12, 2006 Response at 1.

[14] *Id.* at 5.

transactions with CESI or any other affiliate for purposes of purchasing power as necessary to fulfill the Company's public service obligations; and (8) directed Delmarva to serve a copy of such Order by first class mail to government officials as set forth therein.

A second public hearing was held on June 6 and 7, 2006. Counsel appearing at the first public hearing also appeared at the second hearing. The following witnesses testified on behalf of Delmarva: J. Mack Wathen, Vice President, Regulatory Affairs, Pepco Holdings, Inc. – Pepco/Delmarva Power/Atlantic City Electric; Peter E. Schaub, General Manager, Energy Supply of PHI Service Company, a subsidiary of Pepco Holdings, Inc. ("PHI"); and Joseph F. Janocha, Senior Regulatory Lead – PHI Rates and Technical. Scott Norwood, President of Norwood Energy Consulting, L.L.C., testified on behalf of Consumer Counsel. Thomas E. Lamm, Assistant Director in the Commission's Division of Energy Regulation, testified on behalf of Staff. In addition, the following public witnesses testified in opposition to all or part of Delmarva's requests: the Honorable Lynwood W. Lewis, Member, House of Delegates of Virginia; the Honorable Nick Rerras, Member, Senate of Virginia; Ron Wolff, Supervisor of Election District 2, Accomack County; Ben Thomas; Steve Miner, County Administrator, Accomack County; and Joe Bongiovanni.

The Commission also received over 100 written and/or electronic comments in opposition to all or part of Delmarva's requests. Those submitting comments include: residential and business customers of Delmarva; the Honorable John Warner, Member, United States Senate; the Honorable Nick Rerras, Member, Senate of Virginia; Accomack County Board of Supervisors; Accomack County Department of Social Services; Northampton County Board of Supervisors; Town of Chincoteague; and Town of Wachapreague.

Finally, prior to the hearings Delmarva, Staff, and Consumer Counsel filed legal memoranda on the applicability of the MOA to this proceeding. Consumer Counsel states that

the "Company's proposal is inconsistent with the MOA because the Company proposes fuel recovery greater than what it would have received had it not divested its generation assets, as calculated by the MOA's Fuel Index Procedure."[15] Staff likewise "respectfully requests that the Commission find and determine that the Fuel Index Procedure of the MOA establishes a cap on the Company's fuel factor increases sought in this proceeding, consistent with the terms and conditions of the Commission's June 29, 2000 Order [in Case Nos. PUE-2000-00086 and PUA-2000-00032], and the provisions of § 56-582 B (i) of the [Code]."[16]

Delmarva responds that the provisions of the MOA "do not foreclose the Commission from inquiring into the reasons for the increasing costs of electric power to Delmarva and its Virginia customers or from reviewing those costs in the context of the substantial savings that have been part of the electric service to these customers since Delmarva divested its generating assets in 2000-2001."[17] The Company asserts that the "Supreme Court of Virginia has long held that the Commission 'must exercise its informed judgment within a zone of reasonableness.'"[18] Delmarva states that the "Supreme Court of Virginia has noted the fundamental tenet of ratemaking is a matching of revenues with expenses – a principle totally ignored by the Staff and [Consumer Counsel] in this proceeding. . . ."[19] The Company contends that "[t]his matching principle applied in this proceeding means the Commission cannot ignore the costs of purchased power that will be incurred from June 1, 2006-May 31, 2007 to serve Delmarva's Virginia

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[15] Consumer Counsel's April 25, 2006 Legal Memorandum at 8.

[16] Staff's April 25, 2006 Legal Memorandum at 17-18.

[17] Delmarva's May 2, 2006 Response at 1.

[18] *Id.* at 2 (footnote omitted).

[19] *Id.* at 5 (footnote omitted).

customers when setting the fuel factor for those customers for that identical time period."[20] Delmarva concludes that the "Supreme Court of Virginia requires that the Commission balance its discretion with a reasonable result. . . ."[21]

NOW THE COMMISSION, having considered the record, the pleadings, and the applicable law, is of the opinion and finds as follows.

Memorandum of Agreement

We find that the Fuel Index Procedure contained within the MOA should be utilized to establish Delmarva's fuel rate in this proceeding. The Fuel Index Procedure is designed to estimate the fuel costs that would have been incurred had Delmarva not chosen to divest its generation. Indeed, the Fuel Index Procedure was approved by the Commission to address the exact situation presented by this case; *i.e.*, Delmarva's purchased power costs are higher than the estimated fuel costs that would have been incurred had Delmarva not divested its generating assets. This situation is explained in the Commission's Final Order[22] approving Delmarva's requested divestiture:

> As emphasized in the Staff Report, the Company's [original] Plan would effectively remove the embedded cost of its generating assets from base rates and recover purchased power costs through the fuel factor. As such, the Company's overall rates could potentially exceed what Delmarva's capped rates would have been if the Company had not divested its generating assets. Consequently, ratepayers would be deprived of rate cap protections if energy acquired from competitive markets reflects a *higher cost* than would have been incurred had Delmarva continued to own its

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[20] *Id.* at 5-6.

[21] *Id.* at 6 (footnote omitted).

[22] *Application of Delmarva Power & Light Co. For approval of a plan for functional separation of generation pursuant to the Virginia Electric Utility Restructuring Act*, Case No. PUE-2000-00086, and *Application of Delmarva Power & Light Co., Conectiv Delmarva Generation, Inc., and Conectiv Energy Supply, Inc. For approval of transactions under Chapters 4 and 5 of Title 56 of the Code of Virginia*, Case No. PUA-2000-00032, 2000 S.C.C. Ann. Rep. 499 (June 29, 2000) ("*Divestiture Order*").

> generation *and these higher purchased power costs were recovered through the fuel factor.*[23]

In approving Delmarva's proposed divestiture as modified by the MOA, the Commission concluded that the Fuel Index Procedure resolved this problem by assuring that these potentially "higher purchased power costs" would not result in higher rates during the capped rate period. Under the heading "Findings concerning *capped rate* service," the Commission found as follows:

> *Delmarva's original Plan could have resulted in higher rates.* Capped rates would be higher in the future if the cost of power procured from the competitive market is higher than what the embedded costs of the Company's generating assets would have been. The proposed MOA sets forth a number of provisions that seek to resolve this potential problem and to assure that the Company's customers are not adversely impacted by the proposed divestiture.
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> . . .
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> Under the MOA, Delmarva has agreed to: . . . *establish a fuel index mechanism for determining its fuel factor* effective January 1, 2004, and until the end of the capped rate period and the elimination of Delmarva's default service obligations;
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> . . .
>
> We find that the above provisions are in the public interest and that they will benefit Delmarva's customers.[24]

We find that it is reasonable to implement the MOA's Fuel Index Procedure in this case for its intended purpose.

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[23] *Id.* at 501 (emphasis added).

[24] *Id.* at 501-502 (emphasis added). The express terms of the Fuel Index Procedure also explain the rate protections for which it was established:

> After the sale of its generating assets, Delmarva intends to meet its obligations to serve Virginia retail customers using purchased power agreements. Concerns were raised by Staff as to the potential for future increases in fuel rates as the result of changes in market prices of purchased power agreements relative to the fuel costs that would have been realized in the absence of a sale of the generating units.

MOA, Attach. 2 (Lamm, Ex. 16, Attachment I).

Delmarva argues, however, that the MOA's Rate Case Protocol necessitates a different conclusion in this proceeding.[25] We disagree. The Rate Case Protocol and the Fuel Index Procedure are separate attachments to the MOA. The Rate Case Protocol is designated as Attachment 1 to the MOA. The Fuel Index Procedure is Attachment 2. The full title of Attachment 1 is "Rate Case Protocol *For Default Service Rates Under Va. Code § 56-585.B.3*," and by its express terms

> is applicable *only* if: (a) price caps have terminated either by Commission action or by operation of law and [Delmarva] is the default service provider of supply services after such termination; and (b) the Commission has not previously or contemporaneously designated an alternative default service provider of supply services.[26]

Price caps have not been terminated. This is not a proceeding under *§ 56-585* of the Code. Rather, we are modifying Delmarva's capped rates under *§ 56-582*. The Rate Case Protocol is not applicable herein.

We also note that in accordance with the express terms of the Rate Case Protocol, the *Divestiture Order* addresses the Rate Case Protocol as part of the "Findings concerning default rate service" – not as part of the findings regarding capped rates.[27] Delmarva asserts, however, that it is "nonsensical" to ignore the Rate Case Protocol in a capped rate proceeding.[28] We again disagree. By its own terms the Rate Case Protocol serves a separate purpose, pursuant to a separate statute, and requires separate calculations in addition to those in the Fuel Index Procedure. We find that abiding by the plain language of the Rate Case Protocol and, thus,

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[25] *See, e.g.,* Tripp, Tr. 94-98; Delmarva's April 16, 2006 Response at 3-5.

[26] MOA, Attach. 1 (Lamm, Ex. 16, Attachment I) (emphasis added).

[27] *Divestiture Order* at 502.

[28] Tripp, Tr. 96.

implementing the Fuel Index Procedure on a stand-alone basis for the purpose of modifying capped rates, does not render a "nonsensical" result.

Risks and Benefits of Divestiture

The Company also contends that the Commission cannot establish a fuel rate based on the Fuel Index Procedure without exercising discretion required by Virginia law. Specifically, Delmarva asserts as follows:

> The Supreme Court of Virginia has long held that the Commission 'must exercise its informed judgment within a zone of reasonableness.'
> . . .
> The Supreme Court of Virginia has noted the fundamental tenet of ratemaking is a matching of revenues with expenses – a principle totally ignored by the Staff and [Consumer Counsel] in this proceeding. . . . This matching principle applied to this proceeding means the Commission cannot ignore the costs of purchased power that will be incurred from June 1, 2006-May 31, 2007 to serve Delmarva's Virginia customers when setting the fuel factor for those customers for that identical time period.
> . . .
> The Supreme Court of Virginia requires that the Commission balance its discretion with a reasonable result: . . . 'It is the duty of the Commission to set rates which are reasonable and fair, both to the public and the utility.'[29]

The "Company, in fact, requests only that the Commission exercise its authority and carry out its traditional administrative role, which is to review the facts and the law to reach a judgment that is just and reasonable to the regulated company and its customers given the circumstances that exist."[30]

In this regard, Delmarva asserts that "the divestiture resulted in an after tax loss to the Company of $6 million," compared to "$51.7 million of gains to our Virginia customers since

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[29] Delmarva's May 2, 2006 Response at 2, 5-6 (footnotes omitted).

[30] *Id.* at 2.

2000."[31] The Company states that "to suggest Delmarva should simply forego [$8.2 million ($5.0 million after taxes)] of purchased power costs by a mandatory application of an historic 'proxy' calculation" – when its net income in 2005 was only $2.4 million – "raises fundamental issues of fairness and legality."[32] We have considered these circumstances. We have reviewed the law and facts in this proceeding and, in our judgment, conclude that a fuel factor established pursuant to the Fuel Index Procedure results in capped rates that are reasonable and fair both to the public and the Company.

In 2000, Delmarva sought Commission approval of the Company's plan to divest all of its generating units. Delmarva was not required by any Virginia law to divest its generation. Indeed, § 56-590 of the Code, in effect since 1999, *prohibits* the Commission from requiring any incumbent electric utility, such as Delmarva, to divest itself of any generation. The decision to divest was a decision made by Delmarva. That decision created a number of risks for ratepayers. The *Divestiture Order* and MOA addressed those risks and, as a result, included numerous provisions for the protection and benefit of ratepayers.[33] The ratepayer benefits that Delmarva asserts have accrued since 2000 are the type of benefits reasonably captured by the *Divestiture Order* and MOA. Similarly, the capped rate protections commencing under the MOA in 2004 represent another set of ratepayer benefits and likewise were part of the conditions necessary for the Commission to approve the requested divestiture in 2000. Any benefits that ratepayers may have received under the MOA since 2000 do not render unreasonable the Commission's decision to implement, now, the specific capped rate protections that were expressly adopted for 2004 and

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[31] Wathen, Ex. 10 at 9-10.

[32] Delmarva's May 2, 2006 Response at 5; *see also* Wathen, Ex. 10 at 6-7.

[33] The MOA was a voluntary agreement negotiated between Delmarva and Staff, which Delmarva filed with the Commission and asked the Commission to adopt as part of the Company's divestiture plan. *See, e.g., Divestiture Order* at 1.

beyond. To the contrary, we find that permitting the Company to charge the "higher rates" that the *Divestiture Order* and MOA were explicitly designed to prohibit would result in capped rates that are unreasonable and unfair to ratepayers.

Delmarva further supports recovery of its purchased power costs by asserting that, "[u]nfortunately, the world's rising energy costs affect Delmarva as they affect other suppliers and end users."[34] Our decision herein does not ignore rising fuel prices. The Fuel Index Procedure is specifically designed to reflect the estimated increase in fuel prices that Delmarva would have incurred if it had not chosen to divest its generation. In the instant case, Delmarva's purchased power costs – resulting from a solicitation process in the wholesale market – exceed the estimated increase in fuel prices. This indicates that higher fuel costs are not the sole reason for recent rate increases in the mid-Atlantic region. In Virginia, if capped rates did not presently exist and prices were set by Delmarva's claimed market price, ratepayers on the Eastern Shore could see a rate increase of about 50% or greater.

We find that the difference between (1) the increased estimate of fuel prices under the Fuel Index Procedure, and (2) Delmarva's current purchased power costs, represents precisely the "higher rate" from which consumers are protected by the *Divestiture Order* and MOA. Delmarva now argues, however, that it did not intend to put the Company at risk for the difference between the Fuel Index Procedure and its purchased power costs.[35] As noted above, though, the *Divestiture Order* explains that: (1) under Delmarva's original plan for divestiture, "ratepayers would be deprived of rate cap protections if energy acquired from competitive markets reflects a higher cost than would have been incurred had Delmarva continued to own its generation and these higher purchased power costs were recovered through the fuel factor;"

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[34] Wathen, Ex. 10 at 3.

[35] Tripp, Tr. 65.

(2) accordingly, "Delmarva's original plan could have resulted in higher rates;" (3) as a result, the MOA includes provisions that seek "to assure that the Company's customers are not adversely impacted by the proposed divestiture;" and (4) thus, "Delmarva has agreed to: . . . establish a fuel index mechanism for determining its fuel factor effective January 1, 2004, and until the end of the capped rate period and the elimination of Delmarva's default service obligations."[36] Delmarva's assertion of its past intentions stands in stark contrast to the plain language of the *Divestiture Order* – an order that was necessary for Delmarva to effectuate its desire for divestiture – and thus is not persuasive.

Finally, the *Divestiture Order* and MOA do not speculate on nor limit the benefits, quantitative or qualitative, that could accrue to the Company by divesting all of its generating units. For example, in May 2000 Delmarva publicly stated that it expected to net approximately $1 billion from divestiture.[37] In accepting the *Divestiture Order* and MOA, Delmarva's management made a voluntary business decision in which the Company agreed to a number of potential risks and benefits necessarily associated with its decision to embark on the path to divestiture. An analysis of possible risks and benefits inuring to the Company as a result of such transactions should, and indeed may, have been part of the calculus used by Delmarva's management in deciding whether to carry out divestiture.

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[36] *Divestiture Order* at 501-502.

[37] On May 22, 2000, Delmarva issued a news release explaining its divestiture plan as follows:

> In May 1999, Conectiv outlined a series of strategic and financial steps designed to increase shareholder value and provide for improved earnings growth. A key initiative was the sale of non-strategic coal and nuclear baseload generating assets. The sales are expected to net about $1 billion in proceeds for the company when they close later this year. . . . The $1 billion gives us resources to invest in our core businesses as well as to optimize our capital structure.

Ex. 13 at 3.

Nonetheless, Delmarva now states that it "will be forced to review its operations in Virginia as the Company cannot sustain repeated losses that may follow approval of the use of an historic 'proxy' methodology to determine this and future fuel factors. As financial stewards of the Company, we would be required to determine how Delmarva's service in Virginia can obtain a positive return for the Company and its stockholders."[38] The Commission is not unmindful of this testimony. The Commission is not obligated and, indeed, finds that it would be unreasonable, to modify the *Divestiture Order* and MOA *post facto* and to force ratepayers to rescue the Company from the results of its own economic business decisions. In this instance, any claimed losses to the Company do not result from destruction of economic value by the Commission but, rather, represent value that has been lost as a consequence of economic forces to which Delmarva is subjected as a direct result of its own business decisions, decisions that Delmarva freely made and which were not forced upon the Company by the Commission.

Fuel Rate

Delmarva witness Janocha testifies that the Fuel Index Procedure estimates fuel costs that otherwise would have been incurred absent divestiture "by selecting market fuel prices by type (coal, oil, natural gas) as inputs, converting those prices into a cost/MBTU for each generating station, and then allocating those costs according to the fuel mix that resulted for 1999 operations."[39] Mr. Janocha presents a proxy calculation using "average market fuel prices, at the delivery points where title to the commodity was transferred, for the 12 months ending December 2005," and a "proxy calculation for 2006, using forward market prices and the sales forecast."[40] In this regard, Delmarva witness Wathen states that the Company's fuel factor

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[38] Wathen, Ex. 10 at 11.

[39] Janocha, Ex. 8 at 4.

[40] *Id.*

calculation using calendar year 2005 data equals 5.2257 cents per kWh, and its "calculation for fuel costs for calendar year 2006 equals 6.4723 cents per kWh."[41] Mr. Wathen objects, however, to using calendar year 2005 data and contends that using such "historical fuel costs to collect future prices in a volatile commodities market does not provide reliable results."[42] Rather, Mr. Wathen states that the fuel index calculation "should be based on the time period during which the power is to be supplied, not an historical period."[43]

Consumer Counsel witness Norwood states that the Fuel Index Procedure adjusts "the Company's 1999 fuel factor to reflect growth in actual fuel costs from 1999 through the 12-month period immediately proceeding the period in which the new rates will be in effect."[44] Mr. Norwood testifies that "Delmarva's maximum fuel charges for 2006 are capped at a level that is no higher than the Company's 1999 fuel factor adjusted to reflect the actual increase in fuel costs from 1999 to 2005."[45] Mr. Norwood, however, asserts that the Company's proxy calculations do not follow "the method specified under the Fuel Index Procedure" and do not provide "a valid calculation of the proxy fuel charge for 2006 as specified by the Fuel Index Procedure."[46]

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[41] Wathen, Ex. 10 at 5.

[42] *Id.*

[43] *Id.*

[44] Norwood, Ex. 15 at 7.

[45] *Id.*

[46] *Id.* at 8.

Staff witness Lamm states that "[a]t its most basic level, the Fuel Index Procedure provides for escalating or de-escalating Delmarva's 1999 Virginia fuel expenses . . . for future fuel price changes."[47] Mr. Lamm describes the calculation as follows:

> The procedure assumes a fixed 1999 net energy supply mix (percent of total energy supply by company generation by fuel type and net purchases). The escalation of 1999 fuel expenses is accomplished by applying a fuel cost growth factor or Fuel Composite Ratio, which is calculated by dividing a future year's Weighted-Average Fuel Cost Index by the 1999 Weighted-Average Fuel Cost Index.[48]

Mr. Lamm's calculation results in a fuel factor of 5.6185 cents per kWh.[49]

We find that Mr. Lamm's calculation of the 2006 fuel factor complies with the method established by the Fuel Index Procedure. First, Mr. Lamm calculates a Weighted-Average Fuel Cost Index for 2005, which equals $3.7014 per MBTU. In this calculation, Mr. Lamm appropriately uses historical fuel type indices for the twelve months ended December 31, 2005. We find that the Fuel Index Procedure expressly contemplates using actual, historical data from specific publications as inputs to the Fuel Cost Index and that this results in a reasonable calculation for the purposes set forth therein.[50] Next, Mr. Lamm divides $3.7014 per MBTU by the Weighted-Average Fuel Cost Index for 1999 ($1.3415 per MBTU) to get the Fuel Composite Ratio required by the Fuel Index Procedure; this ratio is 2.7592. Finally, Mr. Lamm multiplies the Fuel Composite Ratio (2.7592) by Delmarva's 1999 fuel expense (2.0363 cents per kWh), which results in 5.6185 cents per kWh.

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[47] Lamm, Ex. 16 at 7.

[48] *Id.*

[49] *Id.* at 9 and Attachment II.

[50] *See* MOA, Attach. 2 (Lamm, Ex. 16 at Attachment I). In addition, Mr. Lamm's calculation of a Weighted-Average Fuel Cost Index properly assumes that net purchased power fuel costs escalate or de-escalate at the same rate as the composite change in the selected fuel type indices. Lamm, Ex. 16 at 7-8.

We find that Delmarva's 2006 fuel factor shall be 5.6185 cents per kWh – an increase of 2.5486 cents per kWh above the current fuel factor of 3.0699 cents per kWh. This represents a price increase of approximately 25% for a residential consumer using 1000 kWh a month, which is an increase of about $25.49 per month.[51] Although this is significantly less than what the Company requested, we recognize that the rate increase we approve today represents a substantial increase for consumers. We have listened to the public witnesses and have reviewed the large number of comments sent in to the Commission by Delmarva's customers. While we reject approximately 43% of the increase sought by the Company,[52] we are still mindful of the significant burden that this rate increase creates for ratepayers on the Eastern Shore. We are keenly aware that this rate increase will work a hardship on Delmarva's customers; however, we must apply the law, pursuant to which we find that Delmarva is entitled to the increased revenues approved herein.

Finally, we direct the Company to file with its next fuel factor application a calculation under the Fuel Index Procedure "consistent with the methodology accepted by the Commission in this proceeding, with supporting work papers and fuel type index source documents, to the extent practicable, no later than March 1st."[53]

Purchased Power Costs

Although we determine above that the 2006 fuel rate shall be set pursuant to the Fuel Index Procedure, we also note that Delmarva's purchased power costs are relevant in establishing the Company's fuel factor. Specifically, § 56-249.6 D 2 of the Code mandates as follows:

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[51] *Id.* at 10.

[52] Delmarva requested an additional $20.0 million in revenues (Capped Rate Adjustment Application at 3), and we herein approve a revenue increase of $11.5 million (Lamm, Ex. 16 at 10).

[53] Lamm, Ex. 16 at 10.

> [T]he Commission shall disallow recovery of any fuel costs that it finds without just cause to be the result of failure of the utility to make every reasonable effort to minimize fuel costs, giving due regard to reliability of service and the need to maintain reliable sources of supply, economical generation mix, generating experience of comparable facilities, and minimization of the total cost of providing service.

In Delmarva's previous fuel factor case, the fuel rate resulting from its solicitation was less than the fuel rate resulting from the Fuel Index Procedure. In that instance the Commission – in accordance with § 56-249.6 D 2 of the Code – approved the fuel rate resulting from the Company's bidding process.[54] As explained above, in the instant case Delmarva's purchased power costs are not the expenses for which we must match revenues; rather, such expenses are determined by the Fuel Index Procedure, which serves as a limit on Delmarva's fuel factor recovery during the capped rate period.

Affiliates Act Application

In our May 16, 2006 Order, we disapproved the Affiliates Act Application without prejudice and granted the Company an interim exemption under § 56-77 B of the Code to engage in transactions with CESI or any other affiliate for purposes of purchasing power as necessary to fulfill the Company's public service obligations. We hereby extend the exemption, pursuant to § 56-77 B of the Code, from the filing and prior approval requirements of § 56-77 A pending further order of the Commission. All other provisions of the Affiliates Act continue to apply to Delmarva.

Accordingly, IT IS HEREBY ORDERED THAT:

(1) In Case No. PUE-2006-00033:

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[54] *Application of Delmarva Power & Light Co. For an increase in its electric rates pursuant to Va. Code § 56-249.6 and § 56-582,* Case No. PUE-2004-00124, Final Order (March 25, 2005). In the instant proceeding, Delmarva witness Schaub asserts that "the bidding process was competitive and did obtain a fair market price" (Schaub, Ex. 4 at 10); however, the fact that there was only one bidder – and that bidder was an affiliate of the Company – raises questions as to whether the resulting price was, in fact, "competitive" (*see, e.g.,* Norwood, Ex. 15 at 10-11).

(a) The Company's fuel factor shall be 5.6185 cents per kWh, effective for usage on and after July 1, 2006.

(b) On or before March 1, 2007, Delmarva shall file an application with the Commission for approval of a fuel rate to become effective June 1, 2007. Such application shall include but is not limited to: (i) the calculation under the Fuel Index Procedure of a fuel factor for 2007 consistent with the methodology set forth herein, with supporting work papers and fuel type index source documents to the extent practicable; and (ii) a description, and the results, of the Company's next purchased power solicitation for Virginia.

(2) In Case No. PUE-2006-00032:

(a) Pending further order of the Commission, Delmarva is granted an exemption from the filing and prior approval requirements of the Affiliates Act, pursuant to § 56-77 B of the Code, to engage in transactions with CESI or any other affiliate for purposes of purchasing power as necessary to fulfill the Company's public service obligations.

(b) The Commission reserves the authority to examine the books and records of any affiliate in connection with the exemption granted herein whether or not the Commission regulates such affiliate.

(c) Delmarva shall include the transactions exempted herein in its Annual Report of Affiliate Transactions submitted to the Commission's Director of Public Utility Accounting.

(d) If Annual Informational and/or General Rate Case Filings are not based on a calendar year, then Delmarva shall include the affiliate information contained in the Annual Report of Affiliate Transactions in such filings.

(3) These matters are dismissed.

AN ATTESTED COPY hereof shall be sent by the Clerk of the Commission to all persons on the official Service List in this matter. The Service List is available from the Clerk of the State Corporation Commission, c/o Document Control Center, 1300 East Main Street, First Floor, Tyler Building, Richmond, Virginia 23219.

Miner, Steven B.
County Aministrator
Board of Supervisors of
Accomack County
PO Box 388
Accomac VA 23301

Davis, Jeffery L.
Chief Executive Officer
Eastern Shore of Virginia
Chamber of Commerce
P.O. Box 460
Melfa VA 23410

Nunez, Katherine H.
County Administrator
Board of Supervisors of
Northampton County

Eastville VA 23347

Rosenstein, I. D.
Esquire
Legal Department
Delmarva Power & Light Company
P.O. Box 231
Wilmington DE 19899

Roussy, Jr., D. M.
Assistant Attorney General
Office of Attorney General
Ins. & Utilities Regulatory Sec
900 East Main Street, 2nd Flr.
Richmond VA 23219

Emge, Kirk
General Counsel
Delmarva Power & Light Company
800 King St
PO Box 231
Wilmington DE 19899

Rerras, Nick
Senator, 6th District
1518 Springmeadow Boulevard

Norfolk VA 23518-4814

Eichelberger, James
Town Manager
P.O. Box 647

Exmore VA 23350

Gary, Richard D.
Esquire
Hunton & Williams LLP
Riverfront Plaza, East Tower
951 E Byrd St
Richmond VA 23219-4074

Browder, C. M.
Sr. Assistant Attorney General
Office of the Attorney General
Division of Consumer Counsel
900 East Main St., 2nd Fl.
Richmond VA 23219

Tripp, III, Guy T.
Esquire
Hunton & Williams LLP
Riverfront Plaza, East Tower
951 E. Byrd St.
Richmond VA 23219-4074

Matsen, Maureen R.
Esquire
Office of the Attorney General
Division of Consumer Counsel
900 E Main Street
Richmond VA 23219